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JAN 28 1959
JAMES R. BROWNING, Clerk

No. 671

IN THE

Supreme Court of the United States

October Term 1958

A. D. JUILLIARD & CO., INC., *Petitioner,*

v.

JAMES W. JOHNSON, Collector of Internal Revenue for the Third District of New York, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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Petitioner prays that a writ of certiorari issue to review the judgment herein of the United States Court of Appeals for the Second Circuit.

OPINIONS BELOW

The majority and dissenting opinions of the Court of Appeals, printed in the Appendix hereto (App. 1a), are reported at 259 F.2d 837 (C.A. 2d 1958). The opinion of the District Court is reported at 166 F. Supp. 577 (S.D. N.Y. 1957). The District Court's Findings of Fact and Conclusions of Law, together

with the District Court's opinion, are printed in the Appendix to Appellant's Brief before the Court of Appeals, nine copies of which have been filed with this petition.

JURISDICTION

The judgment of the Court of Appeals was entered September 29, 1958. (App. 17a). Rehearing was denied October 31, 1958, with one Judge dissenting (App. 18a). The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

QUESTION PRESENTED

Does the deductibility for income tax purposes of a payment to the United States on account of a violation of the Emergency Price Control Act depend on whether such a deduction would frustrate the clearly defined purpose of the Act, or does it depend on whether the taxpayer has a present right to set aside the compromise settlement and recover the payment from the United States?

STATUTE INVOLVED

Internal Revenue Code of 1939:

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or business expenses.—

(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; . . . ."

STATEMENT

In this case, the Court of Appeals for the Second Circuit, which for many years has played a major role in the interpretation of the Internal Revenue Code, has established a novel rule that

(1) is in conflict with the recent decision of this court in *Tank Truck Rentals, Inc.* v. *Commissioner,* 356 U. S. 30 (1958);

(2) will discourage compromises of litigation with the Federal Government;

(3) is in conflict with decisions of the First Circuit in *Commissioner* v. *Pacific Mills,* 207 F.2d 177 (C.A. 1st 1953) and of the Court of Claims in *Lustig* v. *United States,* 138 F. Supp. 870 (1956); and

(4) establishes a different rule for determining deductibility of penalties as business expenses for federal income tax purposes, where the penalties are paid to the Federal Government as distinguished from the governments of the States.

The pertinent facts are as follows:* In 1942 petitioner, a manufacturer of woolen and worsted textile fabrics, was the defendant in the first suit brought by the Price Administrator seeking treble damages and injunctive relief on account of overcharges alleged to be in violation of the Emergency Price Control Act (R. 17a, 144a). Counsel for the Government and petitioner tentatively agreed upon a formula for computing damages for the alleged overcharges in settlement of the

*Page references in this Statement are designated "R." and refer to the Appendix to Appellant's Brief before the Court of Appeals, nine copies of which have been filed with this Petition.

litigation (R. 19a). Before the settlement payment was made, petitioner discovered and reported to the Government that it had made a mathematical error in computing a ceiling price on a fabric not previously included in the settlement, hereafter referred to as fabric A-2391 (R. 19a). As a result, overcharges of $110,098.30 on fabric A-2391 were specifically added to the settlement under the formula previously agreed upon (R. 19a). In 1943 petitioner paid $410,219.31 in settlement of the litigation, of which $330,294.90 represented damages of treble the $110,098.30 overcharge on fabric A-2391 (R. 19a).

After the settlement, petitioner and the Government agreed that the petitioner's ceiling price for fabric A-2391 was higher by 15 cents per yard than the one used in the settlement, and petitioner was authorized to use the higher price in all further sales (R. 26a, 27a). Had this error been discovered prior to settlement of the treble damage action, the overcharges on A-2391 would have been $66,023.76 instead of $110,098.30, and the treble damages paid by petitioner under the settlement would have been $132,223.62 less (R. 27a).

Petitioner deducted the entire $410,219.31 as a business expense under Section 23(1)(a)(1)(A) of the Internal Revenue Code of 1939 in its federal income and excess profits tax returns for 1943; the Commissioner disallowed the deduction, and petitioner brought this suit for refund (R. 4a).

In the District Court petitioner maintained that the entire $410,219.31 was deductible under *Commissioner* v. *Pacific Mills*, 207 F.2d 177 (C.A. 1st, 1953) and *Jerry Rossman Corp.* v. *Commissioner*, 175 F.2d 711 (C.A. 2d 1949) because the overcharges were neither wilful nor due to its failure to take practicable precau-

tions to observe maximum prices. The District Court found that petitioner did not take all practicable precautions, the Court of Appeals affirmed, and petitioner does not seek a review of that factual issue by this Court.[1]

In the District Court petitioner had also maintained that it was at least entitled to deduct the $132,223.62 which was included in the settlement through mutual mistake as to the proper ceiling price of fabric A-2391. The District Court held, however, that the out-of-court settlement took on the character of a judgment because it was referred to in the judgment granting the Government's prayer for injunctive relief and that petitioner could not "collaterally attack" that judgment in this suit for refund (R. 43a-52a). The Court of Appeals agreed with petitioner that the settlement was not part of any judgment but held, nevertheless, that the petitioner was not entitled to a tax deduction of the $132,223.62.

The basis of the Court's holding of primary interest here is the novel legal proposition that an inquiry into the computation of the settlement to find out what any part of the damages had been paid for would constitute a "reopening" of the settlement. The Court held that this would be improper in a tax refund case since it would result in a taxpayer recovering from the Government indirectly money which he could not recover directly by having the settlement set aside. Judge Hincks dissented from this holding on the ground that, under *Tank Truck Rentals, Inc.* v. *Commissioner*, *supra*, the right to deduct the payment depended solely on

[1] A directly opposite result in a similar and certainly no stronger factual situation has recently been reached in the Court of Claims, *Milton S. Kronheim & Co.* v. *United States*, 163 F. Supp. 620 (1958).

whether the deduction would frustrate any sharply defined statutory policy, a test which clearly permits the deduction on these facts.

The Court below also held that the payment to OPA was a lump sum payment, no part of which could be attributed to any specific violation. But this assertion is unsupported in the record and is in direct conflict with the undisputed facts and the findings of the trial judge, never questioned by the Court of Appeals. Judge Hincks in his dissent quickly and properly disposed of this aspect of the case.[2]

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[2] "Judge Leibell's careful and complete findings establish clearly that in the negotiations which followed the filing of the OPA complaint a settlement formula had been tentatively agreed upon which took no account of overcharges on Juilliard's fabric No. A-2391; and that thereafter errors were discovered by Juilliard employees in the Juilliard report on its fabric No. A-2391 which were promptly reported to OPA. The resulting overcharges in No. A-2391 amounted to about $110,000 which OPA insisted be trebled and added to the tentative settlement. This item brought the total amount of the settlement up to $410,219.31. Thus the amount paid by Juilliard for the settlement clearly included the trebled overcharges on fabric A-2391 as Judge Leibell repeatedly stated in his opinion.

"Three months after the settlement had been completed, the appellant reported to OPA a revised basis for the computation of a higher maximum price on A-2391. This was based largely on fabric No. A-2313 which later was found by OPA to be a proper base period fabric to which A-2391 was similar. As a result, OPA allowed a ceiling price of $2.975 per yard for A-2391. Although the fact-basis for this higher ceiling had been in existence and available at and prior to the settlement with OPA, it was not advanced by the appellant nor given effect by OPA until after the settlement. If the overcharge on A-2391 had been computed on the basis of this higher (by 15¢ per yard) ceiling which was subsequently allowed, the amount of the overcharges on A-2391 would have been $44,074.54 less and the trebled damages would have been $132,223.62 less, than the amounts included in the settlement." 259 F.2d at 844-845.

Petitioner filed a petition for rehearing directed solely to the question of the deductibility of the $132,223.62 mistakenly paid at settlement. The petition for rehearing was denied, Judge Hincks again dissenting (App. 18a). It is the holding of the Court of Appeals that this sum is not deductible which petitioner requests this Court to review.

REASONS FOR GRANTING THE WRIT

At the outset, it is important to ascertain as precisely as possible the holding of the majority of the Court of Appeals. It had been established at trial that a part of the payment made to the Government grew out of a mistake as to the ceiling price of a fabric rather than out of a violation of the regulations. It was, and is petitioner's position: (1) that under Section 23(a)(1)(A) of the Internal Revenue Code of 1939 (now Section 162(a) of the Internal Revenue Code of 1954) petitioner has the right to deduct ordinary and necessary business expenses; (2) that under the decisions of this Court, deduction is always permitted unless it would frustrate some statutory objective, a test which can be applied only by ascertaining the purpose for which the payment was made, and (3) that, accordingly, it is always proper, indeed necessary, to ascertain what a payment was made for in order to determine whether the payment is deductible.

The Court of Appeals, however, held that an inquiry into the character of any part of this payment was improper if the inquiry could result in a tax deduction. It took the view that the petitioner agreed that a certain sum of money was owing to the Government, that the Government settled the case on the theory that it

would receive that sum and would keep it. Now, according to the Court of Appeals, the petitioner may not claim a tax deduction on the theory that the settlement was at the wrong figure. The petitioner could not recover from the Government directly on this theory of mistake, the Court of Appeals holds, so petitioner cannot recover the payment indirectly by means of a tax deduction.

This Court of Appeals ruling that some principle of contract law prevents the court from ascertaining the facts on which deductibility for tax purposes depends is clearly in error. Furthermore, as will appear from what follows, this rule injects confusion in an area of law which this Court has but recently seen fit to clarify, is in conflict with the decisions of this and other courts, and may well have a highly undesirable effect on the ability of the Government to terminate litigation by out-of-court compromise.

1. The decision is in conflict with Tank Truck Rentals Inc. v. Commissioner.

The Court of Appeals decision is in conflict, at least in principle, with the decision of this Court in *Tank Truck Rentals, Inc.* v. *Commissioner,* 356 U. S. 30 (1958), and the related cases decided at the same time: *Hoover Motor Express Co.* v. *United States,* 356 U. S. 38 (1958), and *Commissioner* v. *Sullivan,* 356 U. S. 27 (1958). These cases established that the deduction of a business expense is permitted by the Internal Revenue Code in accordance with the clear intent of Congress to tax only net income, *except* where allowance of the deduction would frustrate sharply defined national or state policies. In applying this general rule to determine deductibility of "penal-

ties," the Court specifically approved the holding in *Jerry Rossman Corp.* v. *Commissioner*, 175 F.2d 711, 713 (C.A. 2d 1949), that some penalties are deductible and some are not, and that each case must turn on its own facts. This Court then said that "the test of non-deductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction." 356 U. S. at 35. And, of course, the frustration referred to concerned the objective and purposes of the statute under which the penalty was imposed.

The decision below ignores this test and applies a new and different rule for cases where the payment is made under an out-of-court settlement with the United States. In such cases the decision below proscribes any effort to go behind the face amount of the settlement to ascertain the nature of a payment where doing so might result in a tax deduction, because of a policy against "disruption of settled rights." The Court holds in effect that a deduction is allowable only if the payment itself could be recovered from the Government under contract principles.

Frustration of any national policy is out of the question where a payment sought to be deducted was made and collected under a misapprehension as to liability. Even where a statutory violation has clearly occurred, the objectives of the Emergency Price Control Act have left room for differentiation between wilful or negligent and inadvertent violations in determining deductibility for income tax purposes. *Jerry Rossman Corp., supra* and *Commissioner* v. *Pacific Mills, supra.* Certainly, then, under the test prescribed in *Tank Truck Rentals, Inc.*, the objectives of the statute cannot in any sense prevent deduction of a payment to the

extent that the taxpayer can show the statute was not even violated.[3]

2. The decision below discourages the compromise of claims asserted by the Federal Government.

Federal statutes under which Government claims are compromised every day cover a wide field. To name a few, such statutes include the Sherman Anti-Trust Act, the Robinson-Patman Act, the Food and Drug Acts, the Fair Labor Standards Act, the Safety Appliance Acts, the postal laws, and many others. Compromises of claims under these statutes result from many influences, such as uncertainty respecting liability, dislike of publicity, and the financial condition of the defendant. But while there are many such factors involved, there can be no doubt that income tax considerations

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[3] Judge Hincks' statement on this point in terms of facts of the present case would seem to be unanswerable:

"I fully agree with my brothers that the appellant, having entered into a settlement with OPA, may not now recover back any part of the amount paid. But that is not to say that it is not entitled to a tax deduction. The allowability of a tax deduction as a business expense of damages paid to OPA depends upon whether the overcharges were made inadvertently or under such circumstances that the allowance of a deduction therefor would not frustrate any sharply defined statutory policy. *Jerry Rossman Corp.* v. *Commissioner*, 2 Cir., 175 F. 2d 711, distinguished but not disapproved in *Tank Truck Rentals, Inc.* v. *Commissioner*, 356 U.S. 30.

"In the circumstances of this case, the OPA's subsequent approval of the higher ceiling upon a basis which had existed before the settlement, serves as an authentic demonstration that the overcharges computed on the basis of the higher ceiling would have satisfied the statutory objectives. Consequently, the payments to the extent that they were based on the lower ceiling exceeded what was required to satisfy the statutory objective and a tax deduction in the amount of such excess ($132,223.62) would not frustrate national policy." 259 F.2d at 845.

affect the great majority of all settlements. In suits brought by the Government, the decision below restricts the effect of this one factor, common to most settlement processes, by casting doubt upon the right of the paying party to explain, for income tax purposes, the nature and purpose of the payment made.[4]

After this Court held in *Commissioner* v. *Heininger*, 320 U. S. 467 (1943), that legal expenses of contesting a Post Office fraud order were deductible, the Court of Appeals for the Second Circuit extended the rule there announced to cover deduction of a penalty under the Emergency Price Control Act, reasoning in part that limiting deduction to legal expenses would put a premium upon resistance. *Jerry Rossman Corp.* v. *Commissioner, supra*, 175 F.2d at 713. Yet that Court's decision in this case will have precisely the effect it there sought to avoid. The Court has ignored both the clear policy of the income tax statute to tax net income only and the obvious desirability of encouraging compromises of litigation; and it has done this in order to support the purely theoretical proposition that a tax deduction reduces indirectly the consideration received by the Government in an out-of-court settlement.

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[4] Petitioner would have had a clear right to go behind a judgment of a court awarding the damages paid here, on these facts, to show that the payment was not in fact based on a violation of the regulation. Proof of the error in the tax litigation would raise no problem of *res judicata* because a different cause of action would be involved. *Commissioner* v. *Sunnen*, 333 U. S. 591, 597 (1948). No problem of collateral estoppel would be presented because the specific issue of the overcharge on this item would not have been controverted or litigated in the OPA proceeding. *Commissioner* v. *Sunnen, supra*, 333 U. S. at 599. All of this is clearly recognized by the Court of Appeals. 259 F.2d at 844.

3. The decision is in conflict with decisions of the First Circuit and the Court of Claims.

Insofar as it denies petitioner the right "to dissect" or "to reopen" the compromise for the purpose of establishing a tax deduction the decision below is in conflict with the decisions of the Court of Claims in *Lustig* v. *United States*, 138 F. Supp. 870 (1956), and the Court of Appeals for the First Circuit in *Commissioner* v. *Pacific Mills*, *supra*. Both of these decisions allowed the taxpayer to dissect a settlement in order to establish the tax deductibility of a payment in compromise. In the *Lustig* case, Lustig and several corporations he controlled compromised admitted liabilities for taxes, penalties and interest of approximately $838,000 and $2,654,000, respectively, a total of $3,492,000, for a lump sum payment of $3,200,000. The compromise was effected by a statutory closing agreement. Prior to the settlement, the interest due on Lustig's individual liability was $67,500, and he deducted this amount of interest in computing his individual taxes for the year the lump sum settlement was paid. The Commissioner disallowed the deduction on the ground that the settlement payment was a lump sum payment in lieu of taxes, penalties and interest and that no allocation of interest could be made.[5] The Court of Claims recognized that the settlement payment was made in compromise of a larger liability, but held that if the amount of the interest included "is ascertainable from the agreement or the circumstances surrounding

[5] The Government has no hesitancy in claiming the right to reopen a settlement and to tax part of a payment it has made as being in fact interest or rent income, even though the collection of the tax reduces the taxpayer's net realization from the settlement. See for instance *Estate of Jacob Restor*, 17 T.C. 1085 (1952).

the agreement, we see no reason for denying a deduction for the interest." 138 F. Supp. at 873. The fact that such a deduction might reduce the Government's net realization from the settlement was irrelevant. The conflict between this ruling and the viewpoint of the majority of the Court of Appeals in this case is complete. The Court below said:

> "We can see no distinction between seeking to reopen in this suit the compromised question of the amount of appellant's liability for the purpose of a tax deduction and seeking to reopen it for the purpose of directly recouping money paid in settlement, which appellant concedes it may not accomplish." 259 F.2d at 844.

In *Pacific Mills*, a liability for treble damages under the Emergency Price Control Act was asserted against Pacific by the Government. It was compromised by agreement of Pacific to pay $2,065,842.02, which was not treble damages, but was some $250,000 in excess of single damages. The Government and Pacific appeared in District Court, filed a complaint, an answer, a stipulation for judgment granting injunctive relief and a judgment. The payment was made and the judgment signed in court, although the issues were not discussed or controverted. When the Commissioner disallowed a deduction of the $2,065,842.02 as a business expense, Pacific appealed to the Tax Court. Over the Government's objections, Pacific was allowed to show, and the Tax Court found, that the $250,000 excess over single damages paid as part of the settlement was not a penalty, but a sum calculated to cover overcharges for a period prior to the period covered by the terms of the settlement.

In both of these cases the taxpayer was permitted to go behind a compromise to prove the character of a portion of the payment made, in order to establish deductibility, even though the deduction reduced the Government's net realization from the settlement. Denial of petitioner's corresponding right to prove deductibility of a part of its payment cannot be rested on the difference that petitioner sought to prove that the amount paid was not due. This is pure rhetoric, for petitioner did not offer such proof to disturb the compromise payment itself any more than did Lustig or Pacific Mills. It sought only to establish the character of the payment so that its deductibility could be determined.

4. The decision discriminates against taxpayers who have compromised claims with the Federal Government.

The decision below necessarily discriminates against taxpayers who have in similar circumstances made a settlement with the Federal Government as opposed to taxpayers who have made such settlements with State and local authorities. The Court disallowed petitioner's tax deduction because its allowance was equivalent to "directly recouping money paid in settlement." 299 F.2d at 844

The authorities cited as denying direct recovery all deal with attempts to reopen a settlement as between the original parties. This reasoning could not apply to payments made in settlements with State or local governments, for a federal tax deduction on account of such payments would not directly or indirectly disturb the sum received by the authority to whom it was paid. If the settlement here had involved a State statute, the deduction could not have been disallowed. Similarly, the rule stated below would not apply in

the case of a State income tax deduction for a payment to the Federal Government.

Considered in the light of this absurd discrimination, it is apparent that the court below has allowed the dual identities of the Federal Government as tax collector and as administrator of federal regulatory statutes to merge and become confused. Heretofore the policies of the income tax laws and of the regulatory statutes have been considered separately, without reference to the fact that the Government is the administrator of both. To carry out the intent of Congress as interpreted by this Court, it is important to preserve the rule that deductibility depends upon frustration of the policy of the statute which precipitated the payment. The fact that a given payment was made pursuant to compromise rather than judgment or was made to federal rather than State or local authorities should be immaterial in determining deductibility.

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully submitted,

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